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COMMERCIAL TRANSACTIONS

by
John Krahmer*

A NUMBER of significant cases were decided in the area of commercial law during the survey period. This Article discusses decisions under the Texas Business and Commerce Code¹ as well as decisions in related areas that directly impact legal planning and practice under the Code. Insofar as possible the discussion of cases has been organized to parallel the order of the chapters of the Code.²

I. GENERAL PROVISIONS—ACCELERATION AND PREPAYMENT CLAUSES

The subject of acceleration has been a perennial issue in Texas commercial litigation during the last several years,³ and the following guidelines can be drawn from the litigated cases. First, before foreclosing the creditor must give notice of an intent to accelerate to provide the debtor with an opportunity to cure a default.⁴ Notice of intent to accelerate must precede the acceleration itself; otherwise, any attempted acceleration will be ineffective.⁵ Second, the creditor must give the debtor notice of the actual acceleration.⁶ If this sequence of notices is properly followed, a court will uphold the acceleration.⁷ A complication in these guidelines results if the note signed by the debtor waives the right to notice of acceleration.

In *Cortez v. Brownsville National Bank*⁸ the court addressed such a waiver and held it effective to waive the debtor's right to notice of intent to accelerate.⁹ The court did not reach the question of whether the debtor had also

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1. TEX. BUS. & COM. CODE ANN. §§ 1.101-11.108 (Tex. UCC) (Vernon 1968 & Supp. 1984).

2. The topics covered in the Code are: Chapter 1, General Provisions; Chapter 2, Sales; Chapter 3, Commercial Paper; Chapter 4, Bank Deposits and Collections; Chapter 5, Letters of Credit; Chapter 6, Bulk Sales; Chapter 7, Documents of Title; Chapter 8, Investment Securities; and Chapter 9, Secured Transactions.

3. See, e.g., *Ogden v. Gibraltar Sav. Ass'n*, 640 S.W.2d 232 (Tex. 1982); *Slivka v. Swiss Ave. Bank*, 653 S.W.2d 939 (Tex. App.—Dallas 1983, no writ); *Bodiford v. Parker*, 651 S.W.2d 338 (Tex. App.—Fort Worth 1983, no writ); *Highpoint of Montgomery Corp. v. Vail*, 638 S.W.2d 624 (Tex. App.—Houston [1st Dist.] 1982, writ ref'd n.r.e.); *McGowan v. Pasol*, 605 S.W.2d 728 (Tex. Civ. App.—Corpus Christi 1980, no writ).

4. *Ogden v. Gibraltar Sav. Ass'n*, 640 S.W.2d 232, 233-34 (Tex. 1982).

5. *Allen Sales & Servicenter, Inc. v. Ryan*, 525 S.W.2d 863, 865-66 (Tex. 1975).

6. *Ogden v. Gibraltar Sav. Ass'n*, 640 S.W.2d 232, 233-34 (Tex. 1982).

7. *Slivka v. Swiss Ave. Bank*, 653 S.W.2d 939 (Tex. App.—Dallas 1983, no writ).

8. 664 S.W.2d 805 (Tex. App.—Corpus Christi 1984, no writ).

9. *Id.* at 808. The waiver clause stated: "Each Maker, Surety and Endorser waives No-

effectively waived the right to notice of the acceleration itself because the creditor had sent a letter demanding payment of the entire balance by a specified time and date. One might theorize that this second notice is also superfluous because the debtor will be aware of the acceleration when the foreclosure occurs or when the property is seized, but this issue has not been litigated.

Beyond the guidelines regarding notice, another major problem for a creditor is the possibility that an acceleration might result in usury or consumer credit violations because of the attempted collection of unearned finance charges. Computerized accounting should facilitate the recalculation of the proper interest charge after an acceleration. Failure to recalculate interest continues to occur, however, and responsibility for correcting the situation rests with the legal profession rather than with accountants. Two recent cases illustrate this point. In *Vela v. Yates Ford, Inc.*¹⁰ a consumer-debtor sued a creditor for an alleged usury violation under the Texas Consumer Credit Code.¹¹ The dispute in *Vela* concerned the number of "odd-days" during the term of an installment contract in which the first payment was scheduled less than one month after the initial date of the contract.¹² The debtor counted fourteen odd-days; the creditor counted fifteen. The difference in the interest charge was \$2.53. According to the court, this difference entitled the debtor to recover twice the time-price differential of the contract as well as reasonable attorneys' fees.¹³ The court rejected the doctrine of *de minimus non curat lex* on the ground that denying a recovery because a consumer's damages, which are not an element of his cause of action, are *de minimus* would be inconsistent with the Consumer Credit Code's policy of discouraging misconduct by creditors.¹⁴

At first glance the *Vael* case might be dismissed as an accounting problem. The Texas Supreme Court, however, has made very clear during the last

title, Presentment for Payment, Demand for Payment and Acceleration of Maturity, and Protest, and agrees and consents that this note may be renewed, or at the time of payment extended, without notice, and without releasing any of the Parties." *Id.* Another recent decision reached a similar result. *See Real Estate Exch., Inc. v. Bacci*, 676 S.W.2d 440 (Tex. App.—Houston [1st Dist.] 1984, no writ). In *Bacci* the clause stated:

In the event default is made in the payment of the principal of this note, or any interest thereon as the same becomes due and payable or in whatever manner its maturity may be brought about, then the legal holder hereof shall have the option without demand or notice to the maker or other person obligated hereon, to declare this note immediately due and payable and may thereupon foreclose the liens given to secure its payment.

Id. at 441.

10. 675 S.W.2d 232 (Tex. App.—San Antonio 1984, writ granted).

11. TEX. REV. CIV. STAT. ANN. art. 5069—1.01 to —15.08 (Vernon 1971 & Supp. 1984). The Texas Consumer Credit Code is not a true code since it is not part of the official Texas codifications, but it has acquired this name by popular usage.

12. This type of installment contract is called "irregular" under TEX. REV. CIV. STAT. ANN. art. 5069—7.03(4) (Vernon Supp. 1984).

13. 675 S.W.2d at 238.

14. *Id.* at 237. The Code's penalty provisions are set forth in TEX. REV. CIV. STAT. ANN. art. 5069—8.01 (Vernon Supp. 1984). Under art. 5069—8.01 a creditor is liable for twice the amount of interest or other amounts charged to a consumer in violation of subtitle 2 of the Consumer Credit Code plus reasonable attorneys' fees.

year that it considers the problem of unearned interest overcharges to be the responsibility of those who draft the legal documents underlying such transactions. In *Jim Walter Homes, Inc. v. Schuenemann*¹⁵ the debtors sued on the theory that the acceleration clauses in a note and a building contract violated the Consumer Credit Code because the clauses provided for the payment of unearned interest in the event of default.¹⁶ The court, over a vigorous dissent, agreed with the debtor that the acceleration clauses provided for collection of unearned interest upon default and that the creditor was subject to a judgment for the recovery of penalties.¹⁷ In the course of its discussion the court made the following comment:

[W]e fail to understand why acceleration clauses are drafted which do not include a sentence expressly disavowing any intention to collect excessive unearned interest or finance charges in the event the obligation is accelerated. . . . To settle the matter clearly in the contract between the parties is a service to the creditor, the debtor, and the taxpayers of this state.¹⁸

Draftsmen should adopt the suggestion of the Texas Supreme Court and include a sentence in acceleration clauses that says, in effect: "The creditor under this contract expressly disavows any intention to contract for, charge, collect or receive any unearned interest or finance charge if the obligation under this contract is accelerated." Such a sentence would at least open the door to proof of the bona fide error defense in usury cases by helping to establish the unintentional nature of an overcharge.¹⁹

II. SALES TRANSACTIONS

A. Scope of Chapter 2

Lease Transactions. The Texas courts remain consistently unwilling to extend the warranty provisions of the Code to lease transactions.²⁰ This refusal to extend the Code provisions by analogy was reaffirmed in *U.S. Armament Corp. v. Charlie Thomas Leasing Co.*²¹ The court based its decision solely on the lack of binding Texas authority holding that the Code warranty provisions should be applied to lease transactions.²² The court did not discuss the policies underlying the pros and cons of extension by analogy.

15. 668 S.W.2d 234 (Tex. 1984).

16. The plaintiff alleged violations of TEX. REV. CIV. STAT. ANN. arts. 5069—6.02(9)(a), —8.01, —8.02 (Vernon 1971 & Supp. 1984).

17. 668 S.W.2d at 332-33.

18. *Id.* at 333 n.6.

19. TEX. REV. CIV. STAT. ANN. art. 5069—8.01(f) (Vernon Supp. 1984), provides that no liability will attach to persons who violate the article if such person can show by a preponderance of the evidence that the violation was unintentional and the result of a bona fide error.

20. See *Hobbs Trailers v. J.T. Arnett Grain Co.*, 560 S.W.2d 85 (Tex. 1978) (transaction was lease, not sale of trailers; parol evidence rule applied); *OJ & C Co. v. General Hosp. Leasing, Inc.*, 578 S.W.2d 877 (Tex. Civ. App.—Houston [14th Dist.] 1979, no writ) (contract was for lease, not sale of computers; not within art. 2).

21. 661 S.W.2d 197 (Tex. App.—Houston [1st Dist.] 1983, writ ref'd n.r.e.).

22. *Id.* at 200.

Materialmen's Liens. In *Buck v. Acme Brick Co.*²³ the court did apply the Code's four-year statute of limitations to the enforcement of a materialman's lien held by a subcontractor.²⁴ A dissenting opinion argued that no sale was made to the owners of the property, but only to the general contractor.²⁵ Under such circumstances, the dissent reasoned, the two-year statute of limitations on actions for debt²⁶ should be applied and the action, therefore, should be barred.²⁷ The development of a consistent legal theory to explain why only some portions of the Code can be extended by analogy would be desirable.

B. Enforceability of Sales Contracts

Statute of Frauds: Confirmations Between Merchants. Under section 2.201 of the Code a writing sent in confirmation of a contract may bind a merchant unless written notice of objection to its contents is given within ten days after receipt of the writing.²⁸ The Commercial Transactions article in last year's issue indicated that a confirmatory writing must clearly be a confirmation and not an offer or counteroffer.²⁹ The case giving rise to that discussion was *Great Western Sugar Co. v. Lone Star Donut Co.*³⁰ In *Great Western Sugar Co.* one party sent a letter stating: "This letter is a written confirmation of our agreement. Please sign and return to me the enclosed counterpart of this letter signalling your acceptance of the above agreement."³¹ The court held that the request that the recipient reply converted the letter from a mere confirmation into an offer.³² The failure of the buyer to object, therefore, did not amount to an acceptance or make the contract enforceable under the Code's statute of frauds.³³ The Fifth Circuit has upheld this summary judgment decision of the trial court,³⁴ thereby resulting in an authoritative Fifth Circuit interpretation of section 2.201.

Contracts Created by Course of Conduct. A contract may be formed under chapter 2 in any manner sufficient to show agreement between the parties, including conduct by both parties that recognizes the existence of a contract.³⁵ A contract created by conduct of the parties was known at common

23. 666 S.W.2d 276 (Tex. App.—Beaumont 1984, no writ).

24. *Id.* at 277; see TEX. BUS. & COM. CODE ANN. § 2.725 (Tex. UCC) (Vernon 1968). Under § 2.725 an action for breach of a contract for sale is barred after four years. *Id.*

25. 666 S.W.2d at 277-79 (Brookshire, J., dissenting).

26. TEX. REV. CIV. STAT. ANN. art. 5526(4) (Vernon 1958), amended by Act of June 13, 1979, ch. 716, § 1, 1979 Tex. Gen. Laws 1768-69, provided for a two-year statute of limitations when the cause of action arose in this case.

27. 666 S.W.2d at 278 (Brookshire, J., dissenting).

28. TEX. BUS. & COM. CODE ANN. § 2.201(b) (Tex. UCC) (Vernon 1968).

29. See Krahmer, *Commercial Transactions, Annual Survey of Texas Law*, 38 Sw. L.J. 207, 210-11 (1984) [hereinafter cited as *1984 Survey*].

30. 567 F. Supp. 340 (N.D. Tex.), *aff'd per curiam*, 721 F.2d 510 (5th Cir. 1983).

31. 567 F. Supp. at 342.

32. *Id.* at 344.

33. *Id.* The UCC's statute of frauds is found at TEX. BUS. & COM. CODE ANN. § 2.201 (Tex. UCC) (Vernon 1968).

34. *Great W. Sugar Co. v. Lone Star Donut Co.*, 721 F.2d 510 (5th Cir. 1983).

35. TEX. BUS. & COM. CODE ANN. § 2.204(a) (Tex. UCC) (Vernon 1968).

law as a contract implied in fact.³⁶ The substance of such contracts may include not only the underlying sales transaction, but also associated peripheral matters such as interest or late charges stated on an invoice that the buyer has paid without objection.³⁷ These additional terms can become part of the contract and be fully enforceable against the buyer even without express agreement.³⁸

In *Industrial Disposal Supply Co. v. Perryman Brothers Trash Service, Inc.*³⁹ the sale of goods on open account was accompanied by an invoice stating that a late charge of one and one-half percent per month would be added after thirty days. The buyer argued that the parties had never agreed to a specific rate of interest and that the interest charge should, therefore, be at the general rate of six percent per annum.⁴⁰ The court held, however, that the dealings of the parties over an eight-to-ten-year time period without objection by the buyer to the late charge provision and the buyer's payment of the stated late charge on two occasions clearly established that the parties had reached an implied agreement for payment of the specified interest rate of one and one-half percent per month.⁴¹ The court noted, however, that no agreement should be implied merely because a buyer fails to object to an interest or late charge provision when the buyer has not actually paid the charge in past dealings with the seller.⁴²

Modification of Contracts by Conduct. In addition to the formation of a contract by course of conduct, the Code permits the modification of a contract in the same manner.⁴³ In *Southwest Industrial Import & Export, Inc. v. Borneo Sumatra Trading Co.*⁴⁴ a buyer knowingly accepted and paid for three shipments of wire at a price greater than that specified in the original contract. In the buyer's action to recover the alleged overpayments, the court held that the buyer had impliedly agreed to the price increase and that the course of conduct of the parties had effectively modified the contract.⁴⁵ A summary judgment in favor of the seller was affirmed.⁴⁶

Unconscionability as a Claim. In the last *Survey* the author noted *North Star Dodge Sales, Inc. v. Luna*⁴⁷ as illustrative of the difference in the treatment of unconscionability as an affirmative defense under the Code and as the basis for a cause of action under the Texas Deceptive Trade Practices Act

36. 1 A. SQUILLANTE & J. FONSECA, WILLISTON ON SALES 199 (4th ed. 1973).

37. See *Preston Farm & Ranch Supply, Inc. v. Bio-Zyme Enters.*, 625 S.W.2d 295, 299-300 (Tex. 1981).

38. *Id.* at 300.

39. 664 S.W.2d 756 (Tex. App.—San Antonio 1983, writ ref'd n.r.e.).

40. The six percent figure is that specified by TEX. REV. CIV. STAT. ANN. art. 5069—1.03 (Vernon Supp. 1984).

41. 664 S.W.2d at 766.

42. *Id.*

43. TEX. BUS. & COM. CODE ANN. § 2.208 (Tex. UCC) (Vernon 1968).

44. 666 S.W.2d 625 (Tex. App.—Houston [1st Dist.] 1984, writ ref'd n.r.e.).

45. *Id.* at 629.

46. *Id.*

47. 653 S.W.2d 892 (Tex. App.—San Antonio 1983), *rev'd*, 667 S.W.2d 115 (Tex. 1984).

(TDTPA).⁴⁸ In *North Star Dodge* the buyer recovered damages for the seller's unconscionable failure to comply with an express warranty to repair various defects in a vehicle purchased from the seller or to refund the purchase price.⁴⁹ Although the buyer prevailed on the unconscionability claim, the court of appeals denied the recovery of damages for mental anguish despite a jury finding that the seller had knowingly committed the unconscionable acts.⁵⁰ During this survey period the Texas Supreme Court reversed the action of the court of appeals and held that damages for mental anguish are recoverable when the defendant has knowingly followed a course of unconscionable action.⁵¹ The supreme court also held that the court of appeals erred in denying recovery for loss of use when evidence of the reasonable rental value of a substitute vehicle was presented, even though the plaintiff had not actually incurred out-of-pocket expenses by renting another car.⁵² The court of appeals was affirmed on the allowance of other damages to the plaintiff.⁵³ In light of the subsequent history of *Luna* during this survey period, the case remains very significant because of its approval of mental anguish as a recoverable element of damage in unconscionability cases and its liberalization of proof for loss of use. The entire sequence of opinions merits careful study.

C. Warranties

Warranties of Title. Another case noted in the last *Survey*⁵⁴ was also reviewed by the Texas Supreme Court during this survey period. In *Big H Auto Auction, Inc. v. Saenz Motors*⁵⁵ the supreme court affirmed the ruling of the lower court that the purchase of an automobile for resale is a "use" under the TDTPA⁵⁶ and that the purchaser was entitled to recover under the Act for breach of the warranty of good title.⁵⁷ Recovery under the TDTPA for breach of the good title warranty was also permitted in *Horta v.*

48. See 1984 *Survey*, *supra* note 29, at 211-12. The Code treats unconscionability as an affirmative defense in TEX. BUS. & COM. CODE ANN. § 2.302 (Tex. UCC) (Vernon 1968). The TDTPA, TEX. BUS. & COM. CODE ANN. §§ 17.41-63 (Vernon Supp. 1984), treats unconscionability as the basis for a cause of action in § 17.50(a)(3).

49. 653 S.W.2d at 901.

50. *Id.* at 898. The court stated that a finding that the unconscionable acts had been committed knowingly for purposes of the TDTPA would not support an award of damages for mental anguish, because knowingly within the TDTPA was not equivalent to the tort concept of willful or malicious, which is required for a recovery for mental anguish. *Id.* at 897.

51. *Luna v. North Star Dodge Sales, Inc.*, 667 S.W.2d 115, 118 (Tex. 1984).

52. *Id.*

53. *Id.* at 120. On remand the court of appeals considered the issues of evidentiary support for mental anguish and loss of use damages and whether the damages awarded by the jury for these items were excessive. *North Star Dodge Sales, Inc. v. Luna*, 672 S.W.2d 304, 307 (Tex. App.—San Antonio 1984, on remand). The court upheld both damage awards. *Id.*

54. *Saenz Motors v. Big H Auto Auction, Inc.*, 653 S.W.2d 521 (Tex. App.—Corpus Christi 1983), *aff'd*, 665 S.W.2d 756 (Tex. 1984); see 1984 *Survey*, *supra* note 29, at 213.

55. 665 S.W.2d 756 (Tex. 1984).

56. TEX. BUS. & COM. CODE ANN. § 17.45(1) (Vernon Supp. 1984). For the court's discussion of the meaning of "use" for purposes of the TDTPA, see 665 S.W.2d at 758-59.

57. 665 S.W.2d at 759. Unless disclaimed, the warranty of title exists by operation of law in every sale of goods transaction. TEX. BUS. & COM. CODE ANN. § 2.312 (Tex. UCC) (Vernon 1968).

*Tennison*⁵⁸ without reference to the decision in *Big H Auto Auction*, probably because of the unavailability of the *Big H* opinion when *Horta* was decided.

In two other warranty of title cases the sellers were also found to have breached their warranties of good title, but the cases went beyond the ordinary warranty litigation.⁵⁹ In both cases the sellers argued that subjecting them to liability for vehicles that turned out to be stolen was unconstitutional because the sellers had relied on the Texas Certificate of Title Act⁶⁰ in purchasing the cars. The sellers contended that Texas was the culpable party rather than the sellers because of state error in issuing incorrect title certificates. The courts in both cases rejected the constitutional claims, and both courts noted that any negligent or improper action by an agent of the state would be a proper basis for a claim against the agents' bonds under section 56 of the Texas Certificate of Title Act.⁶¹

Express Warranties in the Sale of Livestock. While the Texas version of the Code includes a nonuniform amendment excluding implied warranties in the sale of livestock,⁶² the parties to a contract for the sale of livestock are still free to create express warranties as they may desire. In *Villalon v. Vollmering*⁶³ the seller of a bull warranted the animal to be a breeder. The animal turned out to be a nonbreeder, and the buyer sued for replacement or refund as specified in the contract. For reasons not apparent in the opinion, the buyer lost in the trial court, but the appellate court held that sufficient evidence substantiated the buyer's claim that the bull was a nonbreeder and that the seller had the burden of going forward with evidence to prove that the bull was a breeder.⁶⁴ The seller was unable to meet this burden, so the court rendered judgment for the buyer.⁶⁵ In its opinion the court specifically noted that the buyer in a breach of warranty suit is not required to show any particular reliance on the seller's affirmation about the quality of the goods being sold.⁶⁶ This statement by the court helps to correct an erroneous assertion in an earlier decision that a buyer is required to prove reliance to

58. 671 S.W.2d 720 (Tex. App.—Houston [1st Dist.] 1984, no writ) (buyer allowed treble damages under TDTPA because claim for breach of warranty of title to car arose before amendments to that Act).

59. See *Keller v. Judd*, 671 S.W.2d 604 (Tex. App.—San Antonio 1984, no writ); *Doyle v. Harben*, 660 S.W.2d 586 (Tex. App.—San Antonio 1983, no writ).

60. TEX. REV. CIV. STAT. ANN. art. 6687-1 (Vernon 1977 & Supp. 1984). The Certificate of Title Act provides for the issuance of certificates of title for motor vehicles and the recordation of liens on the certificates and gives conditions for transfer and replacement of certificates. *Id.*

61. *Keller v. Judd*, 671 S.W.2d 604, 607 (Tex. App.—San Antonio 1984, no writ); *Doyle v. Harben*, 660 S.W.2d 586, 589 (Tex. App.—San Antonio 1983, no writ). TEX. REV. CIV. STAT. ANN. art. 6687-1, § 56 (Vernon 1977) provides that any designated agent of the state who fails to comply with the provisions of the Certificate of Title Act shall be liable on his official bond for any damages suffered.

62. TEX. BUS. & COM. CODE ANN. § 2.316(f) (Tex. UCC) (Vernon Supp. 1984).

63. 676 S.W.2d 220 (Tex. App.—Corpus Christi 1984, no writ).

64. *Id.* at 223. TEX. BUS. & COM. CODE ANN. § 2.303 (Vernon 1968) provides for this allocation of the burdens of proof.

65. 676 S.W.2d at 223.

66. *Id.* at 222 n.1.

recover damages in a warranty action.⁶⁷

Disclaimer of Warranties. The Code not only permits the free creation of express warranties,⁶⁸ but also permits the disclaimer of warranties and the limitation of remedies for breach when the Code standards for visual conspicuousness and verbal clarity have been met.⁶⁹ Whether a disclaimer or limitation of remedy is "conspicuous" is for judicial decision,⁷⁰ and a motion for summary judgment may properly be used to raise this issue.⁷¹ In *Ellmer v. Delaware Mini-Computer Systems, Inc.*⁷² the court held that a disclaimer of warranty and a limitation of remedy were sufficiently conspicuous to preclude an action for breach under the Code.⁷³ This portion of the decision is established law.⁷⁴ Of greater interest is the court's ruling that the disclaimer and limitation effectively barred the buyer's recovery on a deceptive trade practices claim for breach of warranty.⁷⁵ In support of this branch of its opinion the court cited the Texas Supreme Court's decision in *G-W-L, Inc. v. Robichaux*,⁷⁶ in which a disclaimer of warranty in the sale of a dwelling was held effective to bar recovery on a deceptive trade practices claim.⁷⁷ The *Ellmer* court further held that section 17.42 of the TDTA,⁷⁸ which prevents the waiver of rights under the Act, does not prevent the disclaimer of warranties or the limitation of remedies for breach.⁷⁹

D. Bona Fide Purchase

Entrustment of Possession. Section 2.403 of the Code covers a number of situations in which the owner of goods may create such apparent power in another to sell the goods that an innocent purchaser receives good title even

67. See *General Supply & Equip. Co., v. Phillips*, 490 S.W.2d 913, 917 (Tex. Civ. App.—Tyler 1972, writ ref'd n.r.e.).

68. Express warranties are created under the terms of TEX. BUS. & COM. CODE ANN. § 2.313 (Tex. UCC) (Vernon 1968).

69. *Id.* § 2.316.

70. *Id.* § 1.201(10).

71. *Ellmer v. Delaware Mini-Computer Sys., Inc.*, 665 S.W.2d 158 (Tex. App.—Dallas 1983, no writ).

72. 665 S.W.2d 158 (Tex. App.—Dallas 1983, no writ).

73. *Id.* at 160.

74. See *W.R. Weaver Co. v. Burroughs Corp.*, 580 S.W.2d 76, 81 (Tex. Civ. App.—El Paso 1979, writ ref'd n.r.e.).

75. 665 S.W.2d at 161. The buyer brought the claim under TEX. BUS. & COM. CODE ANN. § 17.42 (Vernon Supp. 1984).

76. 643 S.W.2d 392 (Tex. 1982).

77. *Id.* at 393. *Robichaux* was discussed and criticized in last year's *Survey* for its holding that a disclaimer that did not meet Code standards was nonetheless effective to disclaim an implied warranty of habitability. See 1974 *Survey*, *supra* note 29, at 215-16.

78. TEX. BUS. & COM. CODE ANN. § 17.42 (Tex. UCC) (Vernon Supp. 1984).

79. 665 S.W.2d at 160. On this point, one might argue that disclaimers are distinct from limitations of remedy and that remedy limitations cannot be waived by reason of the provisions of TEX. BUS. & COM. CODE ANN. § 17.42 (Tex. UCC) (Vernon Supp. 1984), while disclaimers, which go to the existence of a warranty rather than to the remedies available for a warranty breach, can be waived. This point was not discussed and, to the best of the author's knowledge, no reported Texas decision has raised the issue. The argument, however, is worth noting.

against the claim of the true owner.⁸⁰ One such situation is the entrustment of goods to a merchant who deals in goods of that kind. In this case the Code protects the expectations of an unwary purchaser who buys from the merchant by creating a power in the merchant to transfer all rights of the entruster to a bona fide purchaser.⁸¹ Such a power is created only upon occurrence of an actual entrustment and only when the merchant deals in goods of that kind. When these circumstances do not exist, the purchaser is guilty of conversion and liable to the owner for the value of the converted property.⁸²

E. Performance Disputes

The Perfect Tender Rule in the Sale of Goods. In an earlier *Survey* article,⁸³ this author criticized the court in *Del Monte Corp. v. Martin*⁸⁴ for applying the general contract rule of substantial performance⁸⁵ instead of the specialized rule developed in sales cases that requires the seller to tender goods that conform to the contract in all respects.⁸⁶ This rule of sales law, known as the "perfect tender rule," has been carried into the Code in section 2.601.⁸⁷ Although the term "perfect tender" should not be taken literally, the requirements that the rule places on the seller and the allocation of burdens of performance and proof differ from those of the substantial performance rule.⁸⁸ Proper application of the Code, therefore, requires that sales cases involving a single delivery of goods be treated differently from general contract cases. Since the erroneous decision in *Del Monte*, the Texas courts have recognized the applicability of the perfect tender rule in sales cases and have disclaimed *Del Monte* as incorrect.⁸⁹

Anticipatory Repudiation. One of the most interesting and difficult areas in

80. TEX. BUS. & COM. CODE ANN. § 2.403 (Tex. UCC) (Vernon 1968).

81. *Id.* § 2.403(b).

82. *Olin Corp. v. Cargo Carriers, Inc.*, 673 S.W.2d 211, 216-17 (Tex. App.—Houston [14th Dist.] 1984, no writ) (bona fide purchasers of fertilizer liable to owner because the warehouse-seller had no title, the owner had not entrusted the fertilizer to the warehouse, and the warehouse was not a merchant in kind).

83. Krahmer, *Commercial Transactions, Annual Survey of Texas Law*, 34 Sw. L.J. 199, 208 (1980).

84. 574 S.W.2d 597 (Tex. Civ. App.—San Antonio 1978, no writ).

85. Under the doctrine of substantial performance, if one party is found to have substantially performed a contract, the other party may not cancel the contract and may become liable for breach if he withholds his own performance, but may sue the substantially performing party for partial breach. See J. CALAMARI & J. PERILLO, *THE LAW OF CONTRACTS* § 11-22 (1977).

86. The rule governing sales transactions appears in TEX. BUS. & COM. CODE ANN. § 2.601 (Tex. UCC) (Vernon 1968).

87. *Id.* The Code distinguishes between single delivery contracts in which a perfect tender is required by § 2.601 and installment contracts in which a substantial impairment of the whole contract must be found to constitute a breach of the whole contract. See *id.* § 2.612.

88. Among the differences are the buyer's power to reject goods, *id.* § 2.602, and the seller's power to attempt a cure of defective tender, *id.* § 2.508.

89. See *Printing Center of Texas, Inc. v. Supermind Publishing Co.*, 669 S.W.2d 779, 784 (Tex. App.—Houston [14th Dist.] 1984, no writ); *Texas Imports v. Allday*, 649 S.W.2d 730, 737-38 (Tex. App.—Tyler 1983, writ ref'd n.r.e.).

the law of sales involves anticipatory repudiation by a seller or buyer. Problems occur at two primary levels, each with its own set of subsidiary issues. These issues involve proof of the repudiation and the appropriate course of future action.

At the first level, the aggrieved party must determine whether a repudiation has actually occurred. In some instances the determination amounts to a simple matter, as when the other party has given unequivocal notice that he will not perform. In other instances the determination is difficult or impossible to make, as when the other party sends a communication that ambiguously discusses difficulties of performance or price increases, but never clearly indicates an unwillingness to perform.⁹⁰ When doubt exists about a party's intention to perform, the Code provides a way to pin down the matter by permitting the other party to demand assurance of performance.⁹¹ The Code specifies the type of assurance required and the time by which the assurance must be given.⁹² A failure to give the assurance of due performance constitutes a repudiation under the Code.⁹³ By using a demand for assurance of performance, the aggrieved party can avoid the problems of an ambiguous communication.

At the second level, once a repudiation has occurred the aggrieved party is faced with choosing a course of future action. Section 2.610 of the Code permits the aggrieved party to await performance by the repudiating party for a commercially reasonable time, or to immediately resort to any remedy for breach.⁹⁴ In either case the aggrieved party may suspend his own performance under the contract.⁹⁵ The buyer's remedies for breach include, but are not limited to, the purchase of covering goods⁹⁶ or an action for damages based on the difference between the contract and the market price.⁹⁷ If a buyer chooses to sue for damages rather than cover, a difficult legal issue is presented. One author has termed this issue as "perhaps the most grizzly interpretative problem in Article 2: when does one measure the market?"⁹⁸ The problem arises because section 2.713 of the Code provides that "the measure of damages for nondelivery or repudiation by the seller is the difference between the market price at the time when the buyer learned of the breach and the contract price."⁹⁹ The phrase "learned of the breach" can be

90. See, e.g., *Reliance Cooperage Corp. v. Treat*, 195 F.2d 977, 979 (8th Cir. 1952); *Puget Sound Marina, Inc. v. Jorgensen*, 3 Wash. App. 476, 475 P.2d 919, 921 (1970).

91. TEX. BUS. & COM. CODE ANN. § 2.609 (Tex. UCC) (Vernon 1968).

92. *Id.*

93. *Id.*; see *International Therapeutics, Inc. v. McGraw-Edison Co.*, 721 F.2d 488 (5th Cir. 1983), which was decided during the survey period and involved the use of an assurance of due performance. In *McGraw-Edison* failure to provide a financial statement was held to be evidence of a repudiation. *Id.* at 492.

94. TEX. BUS. & COM. CODE ANN. § 2.610 (Tex. UCC) (Vernon 1968).

95. *Id.*

96. *Id.* §§ 2.711, .712.

97. *Id.* § 2.713.

98. J. WHITE & R. SUMMERS, *HANDBOOK FOR THE LAW UNDER THE UNIFORM COMMERCIAL CODE* 242 (2d ed. 1980).

99. TEX. BUS. & COM. CODE ANN. § 2.713 (Tex. UCC) (Vernon 1968). The market price is determined as of the place for tender. *Id.*

interpreted three ways in the context of an anticipatory repudiation: (1) when the buyer learns of the repudiation; (2) at a commercially reasonable time following the date when the buyer learns of the repudiation; or (3) when performance is due under the contract.¹⁰⁰ The Texas courts have not yet ruled on the question of when a buyer's damages should be measured in an anticipatory repudiation context. A recent federal decision, however, has addressed this issue. In *Cosden Oil & Chemical Co. v. Karl O. Helm Aktiengesellschaft*¹⁰¹ the court recognized the novelty of the issue under Texas law.¹⁰² With no controlling state decision available, the court meticulously explored the ramifications of the various interpretations of "the time when the buyer learned of the breach" in section 2.713.¹⁰³ One quotation from the opinion seems to reflect accurately the reasoning of the court:

In light of the Code's persistent theme of commercial reasonableness, the prominence of cover as a remedy, and the time given an aggrieved buyer to await performance and to investigate cover before selecting his remedy, we agree with the district court that 'learned of the breach' incorporates section 2.610's commercially reasonable time.¹⁰⁴

The court, therefore, chose the second alternative noted above, and "learned of the breach" was interpreted to mean the date of repudiation plus a commercially reasonable time. As a carefully reasoned decision on a difficult issue, *Cosden Oil* should be a persuasive interpretation for the Texas courts on the question of damages in anticipatory repudiation cases.

F. Remedies

Reclamation of Goods from an Insolvent Buyer. The right of a seller to reclaim goods from an insolvent buyer has a notorious history.¹⁰⁵ Much of the litigation has involved a conflict between the seller's reclamation right provided in section 2.702¹⁰⁶ and the rights of a secured creditor under a chapter 9 security interest.¹⁰⁷ In *United States v. Westside Bank*¹⁰⁸ the Fifth Circuit faced the issue of whether the right of reclamation of an unpaid credit seller extends to the proceeds of goods sold to an insolvent buyer when the competing creditor is not a secured party, but another general unsecured creditor of the same buyer. In *Westside* the primary creditor of an insolvent buyer had foreclosed and sold the buyer's assets and paid in full all secured parties. The seller asserted a priority right to a share of the remaining proceeds on the theory that the right of reclamation was superior to the claims of unsecured general creditors. The court agreed that the seller's right to reclaim had priority over the claims of general creditors because to hold otherwise

100. Further discussion of these three interpretations appears in J. WHITE & R. SUMMERS, *supra* note 98, § 6-7.

101. 736 F.2d 1064 (5th Cir. 1984).

102. *Id.* at 1069-70.

103. *Id.*; see TEX. BUS. & COM. CODE ANN. § 2.713 (Tex. UCC) (Vernon 1968).

104. 736 F.2d at 1073.

105. See J. WHITE & R. SUMMERS, *supra* note 98, § 24-9, and cases cited therein.

106. TEX. BUS. & COM. CODE ANN. § 2.702 (Tex. UCC) (Vernon 1968).

107. *Id.* §§ 9.101-.319 (Vernon Supp. 1984).

108. 732 F.2d 1258 (5th Cir. 1984).

would in effect emasculate the reclamation remedy.¹⁰⁹ Although *Westside* arose in a nonbankruptcy setting, the court theorized that the same result would obtain in bankruptcy.¹¹⁰ Like the anticipatory repudiation issue in *Cosden Oil*,¹¹¹ a seller's right to reclaim proceeds as against general creditors had not been decided previously under Texas law, and the court was required to act on the basis of its own interpretation of the Code.¹¹² *Westside* is another valuable source for Texas courts faced with the seller's right to reclaim.

Seller's Remedies for Breach. One of the seller's remedies provided by the Code for a buyer's breach of contract is resale of the affected goods.¹¹³ If the resale is conducted in a commercially reasonable manner, the seller is entitled to recover the difference between the resale price and the contract price from the defaulting buyer.¹¹⁴ In *Serna, Inc. v. Harman*¹¹⁵ some goods had been resold properly, but the remainder had not. The court held that the seller is entitled to damages based on the resale price for those goods properly resold and may still be entitled to damages based on the difference between the contract price and the market price for those goods not sold in a commercially reasonable manner.¹¹⁶ The Code rejects any doctrine of the election of remedies, the court noted, and whether the pursuit of one remedy bars another remedy depends on the facts of the individual case.¹¹⁷ The court remanded the case to determine if the election of resale should operate as a bar to any other damage recovery on the facts of the case, presumably on the grounds of a waiver or estoppel.¹¹⁸

III. COMMERCIAL PAPER

A. Form of Negotiable Instruments

Interpretation of Prepayment Clause. Chapter 3 of the Code, which covers commercial paper, is replete with descriptions of the proper form for negotiable instruments.¹¹⁹ Despite this detail, questions still arise requiring resort to judicial interpretation on points that the statute does not cover.¹²⁰ *Karam v. Ballou*¹²¹ is a recent example. In *Karam* several notes provided for payment of 180 equal monthly installments, with the first installment due on or before January 1, 1980, and subsequent installments due on or before the

109. *Id.* at 1263.

110. *Id.* at 1264.

111. See *supra* notes 101-04 and accompanying text for a discussion of *Cosden Oil*.

112. 732 F.2d at 1263.

113. TEX. BUS. & COM. CODE ANN. § 2.706 (Tex. UCC) (Vernon 1968).

114. *Id.*

115. 742 F.2d 186 (5th Cir. 1984).

116. *Id.* at 190.

117. *Id.* at 191.

118. *Id.*

119. See TEX. BUS. & COM. CODE ANN. §§ 3.104-.118 (Tex. UCC) (Vernon 1968).

120. For example, despite the frequent use of the terms "maker" and "payee" in the Code, these words are not defined, and resort to pre-Code or non-Code law is required to determine their meaning.

121. 673 S.W.2d 643 (Tex. App.—Texarkana 1984, writ ref'd n.r.e.).

same day of each succeeding month until the notes were paid. The court considered whether the phrase "on or before" allowed prepayments on the notes to be made without penalty. Basing its decision on the pre-Code case of *Lovenberg v. Henry*,¹²² the court held that the notes granted an unlimited right to prepay any or all installments without penalty.¹²³ *Karam* established a clear rule for the proper form of negotiable instruments on the issue of prepayment rights.¹²⁴

Payment from a Particular Source. A provision in an instrument stating that payment is to be made only from a particular fund or source is normally treated as a conditional promise rendering the instrument nonnegotiable.¹²⁵ Instruments issued by a governmental agency, however, may be limited to payment from particular funds or sources, and section 3.105 expressly provides that the limitation does not render such governmental paper conditional.¹²⁶ In *Memorial Point Municipal Utility District v. United Savings Association*¹²⁷ the court apparently overlooked this provision of section 3.105 or the parties never cited the section. A decision that the note was not made conditional by a reference to payment from a particular fund was grounded on general contract law concerning conditions and covenants¹²⁸ and upon a special utility district statute¹²⁹ that was only slightly relevant to the issue.¹³⁰ The court's failure to raise section 3.105 is unfortunate because the section directly addresses the point.

B. Enforcement of Commercial Paper

Holding a Certificate of Deposit "In Due Course." A party becomes a holder in due course of a negotiable instrument by taking it for value, in good faith,

122. 104 Tex. 550, 140 S.W. 1079 (1911).

123. 673 S.W.2d at 645.

124. *Karam* also provided an interesting example of the judicial process. At one point in its opinion the court stated:

The trial court concluded that the prepayment provision of the Cass notes is unambiguous and that the "on or before" provision of the notes presents only a limited right to prepay the following month's installment due under the notes.

We agree that the provision is unambiguous, but conclude that the notes grant a full right to prepay any installment due at any time.

Id. at 644-45. One wonders how unambiguous a note might be when two courts ascribe two opposite meanings to the same language. This quotation could be used as a cogent criticism by example of the "plain meaning rule" in general contract law. *Cf.* *Pacific Gas & Elec. Co. v. G.W. Thomas Drayage & Rigging Co.*, 69 Cal. 2d 33, 35-38, 442 P.2d 641, 643-46, 69 Cal. Rptr. 561, 563-66 (1968) (court interprets contract according to judge's linguistic background; exclusion of extrinsic evidence reflects "primitive faith" in possibility of perfect verbal expression).

125. *See* TEX. BUS. & COM. CODE ANN. §§ 3.104(a)(2), .105(b)(2) (Tex. UCC) (Vernon 1968).

126. *Id.* § 3.105(a)(7).

127. 666 S.W.2d 203 (Tex. App.—Houston [14th Dist.] 1983, no writ).

128. The general contract law on conditions and covenants was drawn from the classic contracts case of *Hohenberg Bros. v. George E. Gibbons & Co.*, 537 S.W.2d 1 (Tex. 1976) (clause describing delivery of instruments to broker not a condition precedent for his liability for breach of contract to deliver cotton).

129. TEX. WATER CODE ANN. § 54.303(a) (Vernon 1972).

130. 666 S.W.2d at 204.

and without notice of defenses to or claims against the instrument.¹³¹ Once a holder in due course qualifies as such, the holder may retain the instrument "free from . . . all claims to it on the part of any person."¹³² The Dallas court of appeals applied these rules in *Dallas/Fort Worth Airport Bank v. Dallas Bank & Trust Co.*¹³³ to protect the holder in due course of a certificate of deposit against a claimed right of set-off asserted by the bank that had issued the certificate of deposit.¹³⁴ The issuing bank contended that it had a perfected security interest in all deposit accounts of the debtor and that this security interest had priority over the claim of a holder in due course to the funds allocable to the certificate of deposit. The court properly held that section 9.105 of the Code¹³⁵ specifically excludes accounts evidenced by certificates of deposit from the definition of "deposit accounts" and, because of this exclusion, the asserted security interest did not attach to the account in question.¹³⁶ The court also noted that a certificate of deposit amounts to a promissory note running from the issuing bank to the holder, and a set-off against the funds would lack mutuality because the holder was not indebted to the bank.¹³⁷ Once the holder became a holder in due course, it was entitled, as a matter of law, to enforce the certificate of deposit free of all claims of the issuing bank.¹³⁸ The lesson of this case is clear: when a negotiable certificate of deposit has been issued, no loan should be made on the security of the funds underlying the certificate unless the lender obtains physical possession of the certificate itself.¹³⁹

Federal Trade Commission Holder in Due Course Rule. In an interesting pair of cases,¹⁴⁰ the Corpus Christi court of appeals considered the effect of the Federal Trade Commission's holder in due course rule¹⁴¹ and its rela-

131. TEX. BUS. & COM. CODE ANN. § 3.302(a) (Tex. UCC) (Vernon 1968).

132. *Id.* § 3.305(a).

133. 667 S.W.2d 572 (Tex. App.—Dallas 1984, no writ).

134. *Id.* at 575-76.

135. TEX. BUS. & COM. CODE ANN. § 9.105(a)(5) (Tex. UCC) (Vernon Supp. 1984).

136. 667 S.W.2d at 574-75.

137. *Id.* at 575.

138. *Id.* at 575-76.

139. This point is consistent with TEX. BUS. & COM. CODE ANN. § 9.304(a) (Tex. UCC) (Vernon Supp. 1984), which, subject to limited exceptions, requires physical possession of an instrument to perfect a security interest in that instrument. The court noted that the holder in due course had met this requirement. 667 S.W.2d at 575; *see also* TEX. BUS. & COM. CODE ANN. § 9.309 (Tex. UCC) (Vernon Supp. 1984) (discussing rights of holder in due course to take instrument free of conflicting and perfected security interest).

140. *Flores v. Charles Thomas Courtesy Ford, Inc.*, 669 S.W.2d 165 (Tex. App.—Corpus Christi 1984, no writ); *De La Fuente v. Home Sav. Ass'n*, 669 S.W.2d 137 (Tex. App.—Corpus Christi 1984, no writ).

141. The Federal Trade Commission's holder in due course rule was adopted by regulation under the official title of "Preservation of Consumer Claims and Defenses." *See* 16 C.F.R. § 433.2 (1984). The rule has been effective since 1976 and requires that any consumer credit contract or note contain the following legend in at least ten-point bold type: "Any holder of this consumer credit contract is subject to all claims and defenses which the debtor could assert against the seller of goods or services obtained pursuant hereto or with the proceeds hereof." *Id.*

tionship to the Texas Consumer Credit Code.¹⁴² In both cases the required FTC notice appeared on consumer credit contracts. In one case, *Flores v. Charles Thomas Courtesy Ford, Inc.*,¹⁴³ the contract also contained a clause stating in effect that the debtor would assert no claims or defenses against the assignee that the debtor might have against the secured party except those granted in the security agreement. The debtor argued that a contract in this form violated section 7.07(6) of the Consumer Credit Code¹⁴⁴ as a matter of law. Based on its decision in an earlier case,¹⁴⁵ the court held that no violation had occurred.¹⁴⁶

In the other case, *De La Fuente v. Home Savings Association*,¹⁴⁷ the contract created a first lien on the debtor's home, certificates of completion had been signed before the work was finished, the contract was negotiated on the same day that it was signed, and the assignee had never given notice of negotiation, all in violation of various provisions of the Consumer Credit Code.¹⁴⁸ The holder contended that it was not liable for any of the violations because it qualified as a holder in due course of the contract documents, including a negotiable note signed as part of the transaction. The court held that the purpose of the FTC rule was to have a holder of paper bear losses caused by actions of the seller; the benefits of the Texas holder in due course doctrine were, therefore, not available when a consumer credit contract contained the notice required by the FTC.¹⁴⁹

C. Defenses to Enforcement of Commercial Paper

The Holder in Due Course and Defenses to Payment. A primary advantage of qualifying as a holder in due course is the ability to enforce an instrument despite the existence of certain defenses on the part of the drawer or maker.¹⁵⁰ Among the defenses that are cut off by a holder in due course are those of misrepresentation and failure of consideration.¹⁵¹ A presumption that the holder is entitled to recover upon the mere production of the instrument unless the defendant establishes a defense further aids the holder.¹⁵² In

142. TEX. REV. CIV. STAT. ANN. arts. 5069—6.05, —6.06, —7.07, —8.01, —13.03 (Vernon Supp. 1984).

143. 669 S.W.2d 165 (Tex. App.—Corpus Christi 1984, no writ).

144. TEX. REV. CIV. STAT. ANN. art. 5069—7.07(6) (Vernon Supp. 1984).

145. *Haley v. Pagan Lewis Motors, Inc.*, 647 S.W.2d 319 (Tex. App.—Corpus Christi 1982, writ ref'd n.r.e.).

146. 669 S.W.2d at 166-67.

147. 669 S.W.2d 137 (Tex. App.—Corpus Christi 1984, no writ).

148. The various sections that had been violated were TEX. REV. CIV. STAT. ANN. arts. 5069—6.05 (prohibiting first liens on dwellings in consumer installment contracts), —6.06(3) (requiring certificates of completion after work is finished), —13.03(b) (prohibiting negotiation of a consumer credit home solicitation sales contract until at least three days after signing), —8.01 (requiring notice of negotiation of the contract to be given by the assignee) (Vernon Supp. 1984).

149. 669 S.W.2d at 142.

150. See TEX. BUS. & COM. CODE ANN. § 3.305(b) (Tex. UCC) (Vernon 1968), for a list of defenses not cut off by a holder in due course.

151. *Id.*

152. *Id.* § 3.307(b).

*Jonwilco, Inc. v. C.I.T. Financial Services*¹⁵³ the court applied both of these principles in holding a defendant liable on an instrument despite allegations of fraud and failure of consideration because the Code presumed the holder to be a holder in due course absent some evidence to the contrary.¹⁵⁴ The court may have gone too far in reaching this decision, however, because *Jonwilco* was decided on a motion for summary judgment and not after a trial on the merits. Section 3.307 requires only that the defendant establish a defense to make the holder prove his holder in due course status, but does not require direct evidence tending to disprove such status at the summary judgment stage.¹⁵⁵ *Jonwilco* required a direct challenge to holder in due course status on a motion for summary judgment, and this requirement may be beyond existing Texas law.

Despite the ability of a holder in due course to cut off many defenses, some defenses supported by important public policy grounds remain effective even against favored holder in due course status.¹⁵⁶ In *Robinson v. Rudy*¹⁵⁷ the defendant alleged that a note was usurious, and the court recognized that this defense would be good even against a holder in due course. The court found, however, that the note in question was not usurious and allowed the holder to recover.¹⁵⁸

Impairment of Collateral as a Defense to Payment. Section 3.606 of the Code discharges a party from liability on an instrument whenever the holder unjustifiably impairs any collateral given as security for the instrument.¹⁵⁹ In *Lowry v. Crimmins*¹⁶⁰ the court decided that the language of section 3.606 discharging any party to the instrument included the maker of a note.¹⁶¹ The court expressly rejected contrary decisions in two earlier cases.¹⁶² The Texas Supreme Court has granted the plaintiff a writ of error; the decision in this case will clarify Texas law on the proper interpretation of section 3.606.

153. 662 S.W.2d 664 (Tex. App.—Houston [14th Dist.] 1983, no writ).

154. *Id.* at 666.

155. TEX. BUS. & COM. CODE ANN. §§ 3.307(b), (c) (Tex. UCC) (Vernon 1968) provides:

(b) When signatures are admitted or established, production of the instrument entitles a holder to recover on it unless the defendant establishes a defense.

(c) After it is shown that a defense exists a person claiming the rights of a holder in due course has the burden of establishing that he or some person under whom he claims is in all respects a holder in due course.

156. These defenses are listed in TEX. BUS. & COM. CODE ANN. § 3.305(b) (Tex. UCC) (Vernon 1968). They include such matters as infancy, illegality, and incompetence. *Id.*

157. 666 S.W.2d 507, 509 (Tex. App.—Houston [1st Dist.] 1983, no writ).

158. *Id.* at 510.

159. TEX. BUS. & COM. CODE ANN. § 3.606(a)(2) (Tex. UCC) (Vernon 1968).

160. 665 S.W.2d 230 (Tex. App.—Eastland 1984, writ granted).

161. *Id.* at 233.

162. *Pan Am. Bank v. Nowland*, 650 S.W.2d 879, 887 (Tex. App.—San Antonio 1983, writ ref'd n.r.e.) (shareholder-signer of voting trust agreement was in position of maker of note executed by trustee and therefore not discharged from liability by § 3.606); *Hooper v. Ryan*, 581 S.W.2d 237, 238-39 (Tex. Civ. App.—Waco 1979, no writ) (§ 3.606 not applicable to comakers on note).

IV. BANK TRANSACTIONS

A. Bank Payments

Forged Indorsements and the Liability of Banks for Conversion. Litigation for conversion of an instrument can occur at two distinct levels in the banking system. A simple example will illustrate these levels. If a check is stolen from a named payee and transferred under a forged indorsement to a collecting bank that obtains payment on the instrument from the payor bank, both the collecting bank and the payor bank are guilty of conversion, and both are potentially liable to the true owner for the amount of the check.¹⁶³ As between themselves, the collecting bank is also potentially liable to the payor bank for breach of the warranty of good title that is created by operation of law when payment is obtained on an instrument.¹⁶⁴ In this fact situation, the true owner may choose between suing at the collecting bank level or, alternatively, bringing a direct action against the payor bank.¹⁶⁵ This fact situation might be varied to include more banks because of a longer bank collection chain or only a single bank if the thief happened to deal directly with the payor bank.

In two cases decided during the survey period, payees successfully maintained actions against payor banks for conversion. Attempts by the payor banks to show that the wrongdoer had been cloaked with apparent authority to negotiate instruments on behalf of the payees were rejected in both cases.¹⁶⁶ In one case the instrument had not been indorsed at all, and the court properly recognized that payment to the wrong party on a missing indorsement is as much a conversion as payment on a forged indorsement.¹⁶⁷

In another conversion case, *Steven-Daniels Corp. v. Commercial National Bank*,¹⁶⁸ the payee chose to sue the collecting bank instead of the payor bank. Section 3.419 of the Code provides that a collecting bank that has acted in good faith and in accordance with reasonable commercial standards "is not liable in conversion or otherwise to the true owner beyond the amount of any proceeds remaining in his hands."¹⁶⁹ The court interpreted this provision to relieve the collecting bank of liability based on jury findings that the bank had acted in good faith and in accordance with reasonable commercial standards.¹⁷⁰ This interpretation is significant because it is the first state court decision in Texas involving this provision of the Code. The

163. See TEX. BUS. & COM. CODE ANN. § 3.419 (Tex. UCC) (Vernon 1968).

164. See *id.* §§ 3.417, 4.207.

165. *Id.* § 3.419.

166. *Ames v. Great S. Bank*, 672 S.W.2d 447, 450 (Tex. 1984); *Continental State Bank v. Miles Gen. Contractors*, 661 S.W.2d 770, 774 (Tex. App.—Fort Worth 1983, no writ).

167. *Ames v. Great S. Bank*, 672 S.W.2d 447, 450 (Tex. 1984).

168. 673 S.W.2d 651 (Tex. App.—Dallas 1984, writ ref'd n.r.e.).

169. TEX. BUS. & COM. CODE ANN. § 3.419(c) (Tex. UCC) (Vernon 1968). Section 3.419 also defines conversion of an instrument and states that the measure of the drawee's liability is the face amount of the instrument and that a payor bank is not liable in conversion solely because it fails to pay proceeds of an item consistently with the restrictive indorsement of one other than the item's immediate transferor. *Id.*

170. 673 S.W.2d at 653.

court distinguished an earlier, contrary interpretation of the same provision that the Fifth Circuit had rendered.¹⁷¹

As noted in the hypothetical above, in a conversion situation a collecting bank may be liable to a payor bank for breach of warranty of good title.¹⁷² In *Fidelity & Casualty Co. v. First City Bank*¹⁷³ the subrogee of the payor bank sued the collecting bank for reimbursement on eighteen checks bearing forged indorsements. The collecting bank successfully defended against the action by demonstrating the checks fell within the "fictitious payee rule" of section 3.405 of the Code.¹⁷⁴ An employee of the drawer used the names of fictitious payees on request forms to cause the drawer to issue checks. The employee then intercepted the checks, forged the payees' indorsements, and cashed the checks at a collecting bank, all according to his original intent. Under the ordinary rules of forged indorsements, the collecting bank would have been liable for a breach of the warranty of good title.¹⁷⁵ Because of the fictitious payee rule, however, the indorsements by the employee were effective to pass good title to the checks.¹⁷⁶

A rather unusual conversion claim arose in the case of *Behring International Inc. v. Greater Houston Bank*.¹⁷⁷ In *Behring* a drawer issued a check to Norwegian American Lines that somehow ended up, without indorsement and without authorization, in the hands of another company, Nordship Agencies, Inc. Nordship deposited the check, without indorsing it, in its own account at a collecting bank. The check was initially paid, but when Behring's comptroller noticed the lack of indorsement, the account entries on the check were reversed, and Behring returned the check to the collecting bank. In the meantime Nordship had gone into bankruptcy. To prevent loss to itself, the collecting bank set-off the amount of the check against some bank accounts that Behring maintained with the collecting bank. Behring sued for conversion of the funds in the accounts. The bank attempted to defend on the ground of negligence on the part of Behring in allowing the check to get into the wrong hands and on the ground that Nordship had apparent authority to negotiate the check. The court ruled against the bank on both contentions.¹⁷⁸ Because the bank had no legal basis on which to exercise a set-off, the court rendered judgment on the conversion claim in

171. *Id.* The court distinguished *Tubin v. Rabin*, 382 F. Supp. 1983 (N.D. Tex. 1974), supplemented, 389 F. Supp. 787, *aff'd*, 533 F.2d 255 (5th Cir. 1976). The *Tubin* court held that a collecting bank was liable to the owner of a check because the special indorsement on the check was forged. The distinction made by the court appears to be incorrect as the basis for the distinction was not at issue in the *Tubin* case. This point is moot, however, because *Tubin* was a federal case interpreting an undecided issue of state law and is not a controlling precedent on the Texas courts.

172. See, e.g., TEX. BUS. & COM. CODE ANN. §§ 3.417(a)(1), 4.207(a)(1) (Tex. UCC) (Vernon 1968). Both sections provide that a person obtaining payment warrants good title to anyone who pays or accepts the instrument. *Id.*

173. 675 S.W.2d 316 (Tex. App.—Dallas 1984, no writ).

174. TEX. BUS. & COM. CODE ANN. § 3.405 (Tex. UCC) (Vernon 1968).

175. See *id.* §§ 3.202, .417(a)(1), 4.207(a)(1).

176. 675 S.W.2d at 317-18.

177. 662 S.W.2d 642 (Tex. App.—Houston [1st Dist.] 1983, no writ).

178. *Id.* at 652.

favor of the plaintiff.¹⁷⁹

Forgery of Drawer's Signature. If a bank pays an item on which the drawer's signature has been forged, the payment is improper, and the drawer can compel the bank to recredit the item to his account.¹⁸⁰ If the drawer has been negligent in handling his checkbook or bank statements, however, the bank may be able to avoid the claim for recrediting.¹⁸¹ In *First National Bank v. Hackworth*¹⁸² the jury found the drawer negligent in permitting employees to have access to her checkbook and bank records.¹⁸³ The jury also found, however, that the bank had not acted in accordance with reasonable commercial standards in paying the checks.¹⁸⁴ The court held that the proximate cause of the loss was the bank's improper action rather than the drawer's negligence, and the bank was required to recredit the account.¹⁸⁵ An interesting and important sidelight to this case was that the action against the bank was maintained by the drawer's estate because the drawer died after suit was filed. In her original complaint the drawer had included a deceptive trade practices claim¹⁸⁶ against the bank. The court held that the claim, whether or not valid, did not survive the death of the drawer.¹⁸⁷

Payments on Restrictive Indorsements and Unauthorized Signatures. In *La Sara Grain Co. v. First National Bank*¹⁸⁸ the bank paid several corporate checks that bore the signature of only one corporate officer instead of the two signatures required. The bank also accepted for deposit to the account of an individual checks that were restrictively indorsed in the corporate name. The bank defended on the basis that the corporation had failed to complain about these erroneous payments within the one-year time period specified in section 4.406 of the Code.¹⁸⁹ The court first held that the signatures on the checks were unauthorized because two signatures were required on checks drawn against the corporate account.¹⁹⁰ The court further held, however, that the bank did not pay the items in good faith because it had the

179. *Id.*

180. TEX. BUS. & COM. CODE ANN. §§ 3.401, 4.401 (Tex. UCC) (Vernon 1968).

181. *Id.* §§ 3.406, 4.406.

182. 673 S.W.2d 218 (Tex. App.—San Antonio 1984, no writ).

183. *Id.* at 223.

184. *Id.*

185. *Id.* at 224.

186. This claim was asserted under the Texas Deceptive Trade Practices Act, TEX. BUS. & COM. CODE ANN. §§ 17.41-.50 (Tex. UCC) (Vernon Supp. 1984).

187. 673 S.W.2d at 221. In another forgery case, *First Nat'l Bank v. Shockley*, 663 S.W.2d 685 (Tex. App.—Corpus Christi 1983, no writ), a bank customer obtained a default judgment against a bank to compel the recrediting of the customer's account. The judgment included claims for violation of the TDTA and was affirmed on appeal. *Id.* at 689-91. The precedential value of this decision is uncertain, however, because the court properly noted that, as an appeal on a default judgment, all allegations in the petition were to be taken as true and a cause of action was sufficiently stated. *Id.* at 687.

188. 673 S.W.2d 558 (Tex. 1984).

189. TEX. BUS. & COM. CODE ANN. § 4.406(d) (Tex. UCC) (Vernon 1968) (customer who fails to discover and report unauthorized indorsement on paid item within one year of when bank made item available is barred from action against bank).

190. 673 S.W.2d at 562.

information necessary to determine that two signatures were required on corporate checks and to determine that various items had been indorsed restrictively.¹⁹¹ Because of the failure to act in good faith, the court ruled that the one-year limitation in section 4.406 was not available as a protection to the bank.¹⁹²

Stopping Payment on Money Orders. For many years Texas law under the Code has provided that neither the issuing bank nor the customer can stop payment on a cashier's check.¹⁹³ In *Interfirst Bank Carrollton v. Northpark National Bank*,¹⁹⁴ a case of first impression in Texas, the court held that the same rule applies to personal money orders purchased from a bank.¹⁹⁵ The court termed a personal money order analogous to a bank money order, thus warranting the treatment accorded a cashier's check.¹⁹⁶

Recovery of Bank Payments by an Action in Restitution. In a very interesting decision, *Greer v. White Oak State Bank*,¹⁹⁷ the Texarkana court of appeals decided that a collecting bank was entitled to recover an amount paid to its customer in a restitution action even though the bank had lost its right to charge back against the customer because of undue delay in giving notice of dishonor.¹⁹⁸ The court reasoned that the Code neither displaces nor conflicts with the equitable right of restitution and that such an action could be maintained unless the customer had changed position in reliance on the payment.¹⁹⁹ In support of its position, the court cited *Bryan v. Citizens National Bank*,²⁰⁰ in which the Texas Supreme Court outlined the scope of a restitutionary recovery under the Code for payor banks.²⁰¹

B. Bank Collections

Immunity of Federal Reserve Banks. In *Childs v. Federal Reserve Bank*²⁰² the Fifth Circuit Court of Appeals held a Federal Reserve bank immune from suit by the owner of an item even though the bank may have been

191. *Id.* at 562-63.

192. *Id.* at 563; see also TEX. BUS. & COM. CODE ANN. § 4.406(a) (Tex. UCC) (Vernon 1968) (customer must use reasonable care and promptness to examine statement and discover unauthorized signature on any item).

193. See *Wertz v. Richardson Heights Bank & Trust Co.*, 495 S.W.2d 572, 574 (Tex. 1973).

194. 671 S.W.2d 100 (Tex. App.—El Paso 1984, no writ).

195. *Id.* at 103.

196. *Id.*

197. 673 S.W.2d 326 (Tex. App.—Texarkana 1984, no writ).

198. *Id.* at 329. A right of charge-back on dishonored checks is provided for collecting banks under TEX. BUS. & COM. CODE ANN. § 4.212(a) (Tex. UCC) (Vernon 1968). The right is lost if the bank fails to give notice of dishonor to its customer by the bank's midnight deadline.

199. 673 S.W.2d at 329.

200. 628 S.W.2d 761 (Tex. 1982).

201. As outlined by the supreme court, a payor bank is entitled to restitution of money paid by mistake only if it shows that its customer had a valid defense to payment of the item. *Id.* at 762-63. Both *Bryan* and *Greer* may be usefully compared with *National Sav. & Trust Co. v. Park Corp.*, 722 F.2d 1303 (6th Cir. 1983). *National Savings* contains an excellent review of the theory of restitution by banks. *Id.* at 1305-06.

202. 719 F.2d 812 (5th Cir. 1983).

negligent in handling a check in the collection process.²⁰³ Although section 4.201 of the Code makes each collecting bank an agent or sub-agent of the depositor,²⁰⁴ Regulation J of the Federal Reserve System severs any agency relationship with depositors and thereby prevents depositor actions against Federal Reserve banks.²⁰⁵

C. Rights of Set-Off

Set-Off Against FDIC on Loan Participations. Because of the increasing number of bank failures, a growing area of banking law has involved the rights of banks that purchase loan participations to set-off the participated loans when the bank originating the participations becomes insolvent.²⁰⁶ Because the Federal Deposit Insurance Corporation (FDIC) acts as the receiver of the insolvent bank, the attempted set-off is made against the FDIC. In *Interfirst Bank Abilene v. FDIC*²⁰⁷ the federal district court allowed a participating bank to set-off loan participations against a correspondent account belonging to an insolvent bank when the claims were in existence before the insolvency, the amount of the claims was certain, and the claims were made in a timely manner.²⁰⁸

V. LETTERS OF CREDIT

Interpretation of a Letter of Credit. A letter of credit is interpreted according to the rules of construction applied to ordinary contracts.²⁰⁹ In *Insurance Co. of North America v. Cypress Bank*²¹⁰ the terms of a letter of credit required "a statement to the effect that [the beneficiary has] not received evidence satisfactory to [it] of the performance of all the conditions and obligations of the aforesaid bond."²¹¹ The beneficiary's letter stated that it had not received satisfactory evidence of the performance of the principal under a bond. The court ruled that reasonable minds could not differ on the compliance of the letter with the terms of the credit and entered judgment for the plaintiff as a matter of law.²¹²

Drafts Under a Credit Can Include Nonnegotiable Drafts. Under a credit

203. *Id.* at 814.

204. TEX. BUS. & COM. CODE ANN. § 4.201 (Tex. UCC) (Vernon 1968).

205. Regulation J, 12 C.F.R. § 210.6(a)(1) (1984).

206. See, e.g., *FDIC v. Bank of Am. Nat'l Trust & Sav. Ass'n*, 701 F.2d 831 (9th Cir. 1983) (set-off permissible only because note purchase agreement contained provision that nothing in agreement should be deemed a waiver of bank's right of set-off); *First Empire Bank v. FDIC*, 634 F.2d 1222 (9th Cir. 1980) (when debt of closed bank is set-off against bank's deposit in another bank, only balance of deposit over set-off is an asset of receivership); *FDIC v. Grella*, 553 F.2d 258 (2d Cir. 1977) (if nondisturbance agreement offered to receiver by landlord was unconditional, receiver could not maintain action on basis of insolvent bank's interest in lease).

207. 590 F. Supp. 1196 (W.D. Tex. 1984).

208. *Id.* at 1200.

209. *Republic Nat'l Bank v. Northwest Nat'l Bank*, 578 S.W.2d 109, 115 (Tex. 1978).

210. 663 S.W.2d 122 (Tex. App.—Houston [1st Dist.] 1983), *reformed*, 674 S.W.2d 781 (Tex. App.—Houston [1st Dist.] 1984, no writ).

211. 663 S.W.2d at 124.

212. *Id.* at 125.

that required the beneficiary to draw on the credit by sight drafts drawn against the issuer, the Texas Supreme Court held that the beneficiary complied with the credit when it presented nonnegotiable drafts.²¹³ The court noted that section 3.104(c) of the Code²¹⁴ does not require instruments to be negotiable to qualify as drafts.²¹⁵ Had the issuer so desired, a term limiting "drafts" to negotiable drafts could have been included in the letter of credit.²¹⁶

VI. SECURED TRANSACTIONS

A. Creation of Security Interests

Common Law Security Interests in Bank Accounts. Under section 9.104 of the Code security interests in deposit accounts are excluded from coverage under chapter 9 unless the account contains proceeds.²¹⁷ According to the court in *San Felipe National Bank v. Caton*,²¹⁸ even though chapter 9 excludes a security interest in a deposit account, the parties, by agreement, may create a common law security interest in such an account.²¹⁹ In *Caton* a note given by a debtor in exchange for a loan gave the bank a security interest in all money on deposit with the bank. The note also provided that this security interest was in addition to any other interests that the debtor gave the bank. The court held that the note gave the bank a common law lien created by contract that would be recognized as a valid equitable claim.²²⁰ This common law security interest gave the bank priority to the accounts as against the claim of a judgment creditor who obtained a writ of garnishment against the funds of the judgment debtor held by the bank.²²¹

The recognition of common law security interests raises some intriguing questions. Is the right to create such a security interest limited to the bank in which the funds of a debtor may be kept?²²² Must such a security interest be created by writing, or will an oral agreement suffice?²²³ What sort of priority does the common law security interest have in relation to a chapter 9

213. *Temple-Eastex Inc. v. Addison Bank*, 672 S.W.2d 793, 797-98 (Tex. 1984).

214. TEX. BUS. & COM. CODE ANN. § 3.104(c) (Tex. UCC) (Vernon 1968). Section 3.104 gives the requirements for a negotiable instrument and defines as species of negotiable instruments certain drafts, checks, certificates of deposit, and notes. *Id.*

215. 672 S.W.2d at 797.

216. *Id.* at 798.

217. TEX. BUS. & COM. CODE ANN. § 9.104(12) (Tex. UCC) (Vernon Supp. 1984).

218. 668 S.W.2d 804 (Tex. App.—Houston [14th Dist.] 1984, no writ).

219. *Id.* at 805.

220. *Id.*

221. *Id.*

222. The court in *Caton* suggested that the bank's interest "was similar to that of pledgor and pledgee." *Id.* If a bailee can hold property for the benefit of someone other than the bailor, limiting the creating of such common law security interests to the depository bank would seem unnecessary. *Cf.* TEX. BUS. & COM. CODE ANN. § 9.305 (Tex. UCC) (Vernon Supp. 1984) (for most kinds of collateral, a security interest may be perfected by possession, and if such collateral is held by a bailee, a secured party is deemed to have possession from the time that the bailee receives notification of the secured party's interest).

223. TEX. BUS. & COM. CODE ANN. § 9.203 (Tex. UCC) (Vernon Supp. 1984), permits oral agreements when the secured party holds the collateral. Perhaps this analogy also applies to bank accounts.

security interest asserting a right to the account as proceeds?²²⁴ What are the relative priorities of a common law security interest against competing claims when the loan transaction involves future advances or after-acquired property?²²⁵ This situation will almost always occur with a deposit account since deposits and withdrawals will probably be made from time to time. *Caton* opens some interesting issues that will undoubtedly arise in future litigation in the area of secured transactions.

B. Priorities

Purchase Money Security Interests in Inventory. In *Ford Motor Credit Co. v. First State Bank*²²⁶ the Texas Supreme Court held that a creditor who first files a financing statement against inventory collateral is entitled to notice from a later purchase money lender if the purchase money lender is to obtain priority over the earlier security interest.²²⁷ A lower court had theorized that such notice was not required when the earlier secured party had filed a financing statement covering inventory, but had not yet entered into a security agreement with the debtor creating a security interest in the inventory as collateral.²²⁸ The Texas Supreme Court rejected this theory on the ground that the security interest attached on the date of the filing of the financing statement.²²⁹ The supreme court decision represents a commendable recognition of the purpose of a notice filing system under which a creditor can file a financing statement to give notice of a possible interest even when the details of a transaction have not been completed.²³⁰ Such a system is workable only when the rights and conduct of the parties are evaluated in light of the records on file within the system.

C. Proceedings After Default

Transfer of Collateral Under a Repurchase Agreement. The normal course of events after a default under chapter 9 is the repossession of collateral by the secured creditor and the disposal of the collateral by sale²³¹ or by retention of the collateral in satisfaction of the debt.²³² A third alternative, by means of transfer under a repurchase agreement, is rarely used in comparison to sale or retention.²³³ This alternative is available if a person other than the debtor is liable to the secured party under a guaranty, indorsement, or repurchase agreement, and that person receives a transfer of collateral from the

224. See *id.* §§ 9.104(12), .105(a)(5).

225. See *id.* §§ 9.204, .312, for the Code treatment of these issues.

226. 676 S.W.2d 486 (Tex. 1984).

227. *Id.* at 487.

228. *Ford Motor Credit Co. v. First State Bank*, 674 S.W.2d 437, 441 (Tex. App.—Tyler 1984), *rev'd per curiam*, 28 Tex. Sup. Ct. J. 80 (Nov. 7, 1984).

229. 28 Tex. Sup. Ct. J. at 81.

230. Some discussions of the Code system of notice filing may be found in TEX. BUS. & COM. CODE ANN. § 9.402 comment 2 (Tex. UCC) (Vernon Supp. 1984).

231. See *id.* § 9.504(c).

232. *Id.* § 9.505.

233. See *id.* § 9.504(e).

secured party following default.²³⁴ Under an agreement of this kind, the secured party is not required to dispose of the collateral by sale or retention, but may compel the guarantor, indorser, or repurchaser to acquire the property according to the terms of their agreement. The Code specifically provides that a transfer of collateral under a repurchase agreement "is not a sale or disposition of the collateral under this chapter."²³⁵ The rules concerning repurchase agreements were applied in *Ley v. Main Bank*²³⁶ to permit recovery for breach of contract against parties who were liable to the secured creditor under a repurchase agreement.²³⁷ Because transfer under a repurchase is not a disposition of collateral, the rule of *Tannenbaum v. Economics Laboratory, Inc.*²³⁸ is not applicable.

Disposition of Collateral. In contrast to transfer of collateral under a repurchase agreement, a secured party who disposes of collateral must follow the standards for notice and commercially reasonable disposition in section 9.504 of the Code.²³⁹ A failure to give the proper notices or dispose of the collateral in a commercially reasonable manner will bar the secured party from recovering a deficiency²⁴⁰ and may result in liability for damages or penalties.²⁴¹ In *First City Bank v. Guex*²⁴² the Texas Supreme Court held that a debtor was entitled to recover ten percent of the principal amount of the original note and the entire amount of the finance charge as a penalty under section 9.507²⁴³ when the secured party failed to dispose of the collateral according to the standards set out in the Code.²⁴⁴ The court further held that the debtor was entitled to recover attorney's fees because the action arose out of a contract between the secured party and the debtor.²⁴⁵

234. *Id.*

235. *Id.*

236. 665 S.W.2d 178 (Tex. App.—Houston [1st Dist.] 1983, writ ref'd n.r.e.).

237. *Id.* at 181.

238. 628 S.W.2d 769 (Tex. 1982). Under *Tanenbaum* a secured party who fails to dispose properly of collateral is barred from recovering a deficiency against the debtor. *Id.* at 772.

239. TEX. BUS. & COM. CODE ANN. § 9.504(c) (Tex. UCC) (Vernon Supp. 1984). Similar standards are applicable if collateral is retained in satisfaction of the debt. *See id.* § 9.505.

240. *Tanenbaum v. Economics Laboratory, Inc.*, 628 S.W.2d 769, 772 (Tex. 1982).

241. *See* TEX. BUS. & COM. CODE ANN. § 9.507 (Tex. UCC) (Vernon Supp. 1984). Section 9.507 gives a debtor a right to recover from a secured party for any loss caused by the secured party's failure to comply with requirements of article 9 such as notice, commercially reasonable disposition, and accounting for any surplus. *Id.*

242. 677 S.W.2d 25 (Tex. 1984).

243. TEX. BUS. & COM. CODE ANN. § 9.507 (Tex. UCC) (Vernon Supp. 1984).

244. 677 S.W.2d at 29-30.

245. *Id.* TEX. REV. CIV. STAT. ANN. art. 2226 (Vernon Supp. 1984), permits recovery of attorney's fees in actions based on contract.